



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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State Controller, Sacramento

TIMOTHY W. BOYER
Interim Executive Director

November 10, 2003

Dear Interested Party:

Enclosed is the *Second Discussion Paper* on proposed amendments to Regulation 1584, *Membership Fees*. This document provides the background, a discussion of the issue and explains staff's recommendation in more detail. Also enclosed for your review is a copy of the proposed amendment to Regulation 1584 (Exhibit 1).

A second interested parties meeting is scheduled for **November 20, 2003 at 10:00 a.m. in Room 122** to discuss the proposed amendments to Regulation 1584. If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please feel free to write to me at the above address or send a fax to (916) 322-4530 before the November 20, 2003 meeting. If you are aware of other persons that may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting. If you plan to attend the meeting on November 20, 2003, or would like to participate via teleconference, I would appreciate it if you would let staff know by contacting Ms. Leila Khabbaz at (916) 324-8483 or by e-mail at leila.khabbaz@boe.ca.gov prior to November 19, 2003. This will allow staff to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing.

Any comments you may wish to submit subsequent to the November 20, 2003 meeting must be received by **December 5, 2003**. They should be submitted in writing to the above address. After considering all comments, staff will complete a formal issue paper on the proposed amendments to Regulation 1584 for discussion at the **Business Taxes Committee meeting** scheduled for **January 27, 2004**. Copies of the formal issue paper will be mailed to you approximately ten days prior to this meeting. Your attendance at the January 27, 2004 Business Taxes Committee meeting is welcomed and encouraged. The meeting is scheduled for **9:30 a.m.** in Room 121 at 450 N Street, Sacramento, California.

Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the "Board Meetings and Committee Information" page on the Board's Internet web site (<http://www.boe.ca.gov/meetings/meetings.htm#two>) for copies of Committee discussion or issue papers, minutes, a procedures manual and calendars arranged according to subject matter and by month.

We look forward to your comments and suggestions. Should you have any questions, please feel free to contact me at (916) 324-1825.

Sincerely,

Charlotte Paliani
Tax Policy Manager
Sales and Use Tax Department

CP: lk

Enclosures

cc: (all with enclosures)

Honorable Carole Migden, Chairwoman
Honorable Claude Parrish, Vice Chairman
Honorable Bill Leonard, Member, Second District (MIC 78)
Honorable John Chiang, Member, Fourth District
Honorable Steve Westly, State Controller, C/O Ms. Marcy Jo Mandel
Ms. Carole Ruwart, Board Member's Office, First District (MIC 71)
Ms. Sabina Crocette, Board Member's Office, First District
Mr. Neil Shah, Board Member's Office, Third District (via e-mail)
Mr. Romeo Vinzon, Board Member's Office, Third District (via e-mail)
Ms. Margaret Pennington, Board Member's Office, Second District (via e-mail)
Mr. Lee Williams, Board Member's Office, Second District (MIC 78 and via e-mail)
Mr. Tim Treichelt, Board Member's Office, Second District (via e-mail)
Ms. Sylvia Tang, Board Member's Office, Fourth District (MIC 72)
Mr. Michael Thomas, Board Member's Office, Fourth District
Mr. Timothy Boyer (MIC 73)
Acting Chief Counsel (MIC 83)
Mr. Ramon J. Hirsig (MIC 43)
Ms. Janice Thurston (MIC 82)
Mr. Warren Astleford (MIC 82)
Mr. Jeffrey Graybill (MIC 82)
Mr. Chris Schutz (MIC 82)
Ms. Jean Ogrod (via e-mail)
Mr. Jeff Vest (via e-mail)
Mr. David Levine (MIC 85)
Mr. Steve Ryan (via e-mail)
Ms. Jennifer Willis (MIC 70)
Mr. Dave Hayes (MIC 67)
Mr. Joseph Young (via e-mail)
Mr. Vic Anderson (MIC 40 and via e-mail)
Mr. Larry Bergkamp (via e-mail)
Mr. Geoffrey E. Lyle (MIC 50)
Ms. Lauren Simpson (MIC 50)

Ms. Leila Khabbaz (MIC 50)
Mr. Peter Horton (MIC 50)

SECOND DISCUSSION PAPER

Application of Tax to Membership Fees when the Person Selling the Membership is not the Person Selling the Tangible Personal Property

Regulation 1584, *Membership Fees*

I. Issue

Should Regulation 1584, *Membership Fees*, be amended to address the application of tax to sales of memberships, when the person who sells the membership is not the same person selling tangible personal property at the membership store?

II. Staff Recommendation

Staff recommends that subdivision (a) of the regulation be amended to clarify that when charges for memberships are subject to tax under subdivision (a)(1)(A) or (a)(1)(B), it is immaterial whether the person who sold the membership is not the person who sells the tangible personal property. Such sales of memberships are regarded as retail sales by the person selling the tangible personal property to a member, measured by the amounts received by the person selling the membership. A copy of staff's recommended amendments to Regulation 1584 is attached as Exhibit 1.

III. Other Alternative Considered

Do not amend Regulation 1584, *Membership Fees*.

IV. Background

At its July 9, 2003 meeting, the Board heard an appeal involving the application of tax to membership fees that entitled members to purchase tangible personal property at warehouse retail stores and on the Internet. Since a membership allowed a person to purchase products for a lower price than a person who had not paid the fee, the membership fees were subject to tax under Regulation 1584. During the hearing, the taxpayer argued that the fees were not subject to tax under Regulation 1584, since the person selling the membership was a separate legal entity from the person selling the tangible personal property, and the entity selling the membership sold no tangible personal property. As a result of this interpretation, the Board directed staff to review this issue and, to the extent a problem is identified, revise the regulation as needed.

Revenue and Taxation Code (RTC) section 6012 defines gross receipts as the total amount of the sale price of tangible personal property without any deduction on account of the cost of materials, labor cost, service cost, losses or any other expense. The Board adopted Regulation 1584 in 1996 to interpret gross receipts as they apply to membership fees. The regulation

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provides in part that membership fees related to the anticipated retail sale of tangible personal property are included in taxable gross receipts when either:

- (A) the retailer sells its products only to members and the membership fee exceeds a nominal amount, or
- (B) regardless of the amount of the membership fee, the retailer sells its products for a lower price to a person who has paid the membership fee than to a person who has not paid the fee.

The regulation further provides that charges for memberships not related to anticipated retail transactions are not subject to tax; for example, a country club fee entitling members to substantial service benefits.

An interested parties meeting was held on September 16, 2003 to discuss possible amendments to the regulation. No written submissions were received after the meeting. This topic is scheduled for discussion at the January 27, 2004 meeting of the Business Taxes Committee.

V. Discussion

Based on the discussion between staff and interested parties at the September 16 meeting, staff considered taking no regulatory action and interested parties did not object. However, after reconsidering the matter, staff decided to incorporate the proposed regulatory language in Exhibit 1 to clarify its position in regard to the application of tax to sales of memberships. Staff's position has been that when membership fees are taxable under Regulation 1584, they remain subject to tax regardless of the party to whom the fees were paid. There is no express language in the regulation that makes the taxability of the membership fees contingent on the memberships being sold by the same entity that makes the related retail sales of tangible personal property.

Generally, membership fees related to anticipated retail sales of tangible personal property at the retailer's outlet stores or on the Internet are charged by the retailer selling the products. Subsequent to the adoption of the regulation, at least one entity has restructured its businesses such that the memberships are sold by a separate entity that is affiliated with the retailer of the tangible personal property. Staff believes that the customer is unaware in such a case of the existence of two entities: the entity selling memberships and the entity selling products. This restructuring has raised questions regarding a purported interpretation of Regulation 1584, namely that the entity selling the membership is selling intangible rights of membership and that such sales are not subject to tax, even though tangible personal property is being sold at lower prices to members than to non-members.

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Regulation 1584, *Membership Fees*

The taxpayer who was the subject of the hearing that triggered this issue no longer sells memberships the gross receipts from which are taxable, and staff is currently unaware of other businesses structured in a manner such that the entity selling the membership is separate from the entity selling the tangible personal property. Nonetheless, to the extent there is potential ambiguity in interpreting the regulation, staff drafted proposed regulatory language to clarify the issue.

Staff believes Regulation 1584 should explain that when retailers make sales of memberships through a separate entity and the sales are taxable under Regulation 1584, the gross receipts from such sales should be included in the taxable measure of the entity actually selling tangible personal property to members. This approach will ensure that the tax on sales of memberships is reported and paid in California when a retailer uses a separate entity to sell its memberships, whether or not such sales are made by an entity engaged in business in this state. A California retailer selling tangible personal property to members directly receives the benefit of the membership sales by having members buy tangible personal property at its facilities even if the membership is sold outside the state by an entity not engaged in business in California. By clarifying that the retailer of the tangible personal property sold to members is responsible to report and pay tax on the gross receipts from the sales of memberships, the potential for retailers seeking to avoid tax on the sale of taxable memberships through the use of out-of-state entities is eliminated.

VI. Summary

Staff recommends adding proposed language to Regulation 1584 to clarify that when sales of membership fees are taxable, it is immaterial that the entity selling the membership fee is separate from the entity selling the tangible personal property. Such sales are regarded as retail sales by the person selling the tangible personal property to a member, measured by the amounts received by the person selling the membership. Staff welcomes suggestions from parties affected by the proposed revisions to Regulation 1584.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of 11/7/2003

Second Discussion.doc rev. 9-30-03

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Regulation 1584. MEMBERSHIP FEES.

(a) APPLICATION OF TAX

(1) IN GENERAL. Membership fees related to the anticipated retail sale of tangible personal property are includible in taxable gross receipts when either

(A) the retailer sells its products only to members and the membership fee exceeds a nominal amount,
or

(B) regardless of the amount of the membership fee, the retailer sells its products for a lower price to a person who has paid the membership fee than to a person who has not paid the fee.

(2) The membership fees described in subdivision (a)(1)(A) or (a)(1)(B) are part of the gross receipts of the person selling tangible personal property to a member. It is immaterial whether the person who sold the membership is not the person who actually sells the tangible personal property to a member. Any sale of a membership described in subdivision (a)(1)(A) or (a)(1)(B) is regarded as a retail sale by the person selling tangible personal property to a member, measured by the amounts received by the person selling the membership.

~~(2)~~(3) INCIDENTAL SALES. Charges for memberships ~~fees~~ not related to anticipated retail transactions are not subject to tax. For example, when a country club or similar organization charges fees (dues) to members and provides substantial service benefits, e.g., the use of golfing, tennis and swimming facilities, the membership fees are not related to sales even though the organization may establish minimum meal and drink purchase requirements for its members.

~~(3)~~(4) CONSUMER COOPERATIVES. Initial or periodic membership fees received by consumer cooperatives, as defined in sections 6011.1 and 6012.1 of the Revenue and Taxation Code, are not subject to tax.

(b) NOMINAL AMOUNT.

(1) For purposes of this regulation, beginning January 1, 2001, the term “nominal amount” means an amount totaling \$45 or less per year subject to increase as provided in subdivision (b)(2). For periods prior to January 1, 2001, the term “nominal amount” for purposes of this regulation meant an amount totaling \$40 or less per year. Amounts received for memberships which are in conjunction with a basic membership (add-ons) are not considered a part of the basic membership fee in determining the nominal amount of the basic membership. Additional cards issued under the same membership number are sales of separate memberships.

(2) During September in the year 2000, and every five years thereafter, the threshold for the nominal amount will be adjusted effective the following January 1, rounded to the nearest \$5, to reflect changes in the California Consumer Price Index (CCPI) whenever that change is more than 5 percent higher than any previous adjustment. For purposes of computing the CCPI increase, the June 30 CCPI index of the computation year will be compared with the June 30 CCPI index of the computation year which resulted in an adjusted nominal amount. For example, for the January 1, 2006 adjustment computation, the CCPI index on June 30, 2005, will be compared with the CCPI index on June 30, 2000. If no adjustment is made at that time, the next comparison will be of the CCPI index on June 30, 2010 with the CCPI index on June 30, 2000.

(c) OPERATIVE DATE.

The provisions of this regulation are operative January 1, 1996.